BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
UNITCO, INC.)

Appearances:

For Appellant: Nathan Schwartz
Attorney at Law

For Respondent: John R. Akin
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Unitco. Inc., against proposed assessments of additional franchise tax in the amounts of $1,732.38, $5,755.53 and $7,482.81 for the income years ended March 31, 1973, 1974, and 1975, respectively.

The primary issue for determination is whether appellant was engaged in a single unitary business both directly and through the United Properties Co. partnership. If it is determined that appellant was engaged in such a unitary business, we must determine whether: (1) the payroll factor should be excluded or adjusted, (2) the sales factor should be adjusted to reflect the difference between gross and net leases, and (3) the sales factor should include the interest from bank deposits and loans to other companies.

Appellant was incorporated in California in 1958, and at all pertinent times its commercial domicile was located in this state. Although early in its corporate existence appellant had been engaged in the construction business, during the appeal years, and for some time prior thereto, appellant was not engaged in any phase of the construction business. During the years in issue, appellant's principal business activity was the rental of improved real property which it owned. Appellant had three shareholders, Ralph W. Kiewit, Jr., John D. Howard, and Jack C. Helms. The three shareholders were also appellant's officers and directors.

Appellant's primary investments included: real estate-holdings in Connecticut, Hawaii and Colorado; a 50 percent general partnership interest in United Properties Co., a partnership owning a high rise office building and stores in California; a bowling alley operation located in California; and a 20 percent general partnership interest in Imperial Valley Bowl Realty. Appellant also owned stocks, bonds, bank deposits, bank certificates of deposit, notes and loans receivable.

The property in Connecticut was a warehouse acquired in 1965 which was leased pursuant to a triple net lease to a single tenant for a term of 30 years with six successive renewal options of five years each. The Hawaiian property consisted of two warehouses acquired in 1970 which were leased pursuant to a triple net lease to a single tenant, one warehouse for 30 years with three successive renewal options of ten years each, and the other for 24 years with six successive renewal options of five years each. The Colorado property consisted of the following four parcels: (1) a small office building acquired in 1972 consisting of four suites which were leased for one- or two-year terms: (2) an apartment building acquired in 1967 with 36 rental units rented for a month-to-month term; (3) a building acquired in 1963 leased to the United States government on a long-term

net-net lease with option to extend the original term; and (4) a shopping center acquired in approximately 1963 with 15 or 16 tenants whose lease terms varied from five to 20 years.

United Properties Co. (hereinafter referred to as "the partnership") was composed of two 50 percent partners, appellant and Ublic Realty Company. Ublic is a wholly-owned subsidiary of United Benefit Life Insurance Company, the primary lender in this partnership real estate venture. Although both partners owned 50 percent of the partnership, uncontested affidavits were submitted on behalf of both partners stating that Ublic was considered the controlling partner with the final say as to all policy matters regarding the operations of the partnership property. Apparently, during the appeal years, no activities other than routine day-to-day operations of the partnership property were undertaken without the prior consent, approval or instructions of Ublic.

Prior to 1972 appellant managed its own real properties and was the managing agent for the real property of the partnership. However, late in 1971, appellant determined to, and did, divest itself of the management of its real property located in Connecticut, Hawaii, and Colorado, as well as the property of the partnership. This transfer of management was accomplished by an agreement between appellant and Unitco Realty & Construction Company, Inc., an unrelated corporation,-1/ whereby the latter, for a fee, agreed to take over the management of all of appellant's real property and the 'property of the partnership.

The management services performed with respect to the Connecticut and Hawaiian properties which were subject to triple net leases involved only bookkeeping services. Under the auspices of the management company, the Colorado property was managed by a resident manager who determined rental rates and negotiated new leases and renewals of existing leases which were forwarded to

1/ Although unrelated to appellant, the president and major shareholder of Unitco Realty & Construction Company, Inc., was also the president and a major shareholder of 'appellant.

California for the signature of appellant's president. The resident manager also arranged for routine repairs and maintenance; decisions regarding extraordinary repairs were made by one of appellant's officers. During the appeal years, none of appellant's officers or directors visited the Connecticut or Hawaiian properties. Two of appellant's officers made a total of four short visits to inspect the Colorado properties during the three appeal years. The management company received substantial fees from both appellant and the partnership for the performance of its managerial services.

During each of the appeal years, the operation of appellant's real property provided a positive cash flow resulting in accumulation of surplus funds which were invested in marketable securities, bonds and other investments.

Appellant's three officers, who were also its sole shareholders, engaged in the following activities during the appeal years: (1) Ralph W. Kiewit, Jr., signed leases forwarded to him by the Colorado resident manager, made two visits to inspect the Colorado property, and in one or two instances authorized extraordinary repairs. He also invested appellant's accumulated funds after consultation with Mr. Howard; (2) John D. Howard made two trips to Colorado and participated in the selection of specific investments for accumulated funds; (3) Jack C. Helms was involved with the bowling alley operations of Imperial Valley Bowl Realty partnership in which appellant had a 20 percent interest. He also assisted in determining appellant's investment policy, but not in the selection of specific investments. Mr. Helms had no managerial responsibilities with respect to appellant's real estate operations or those of the partnership.

Appellant's franchise tax return for each year was filed on a separate accounting basis and reported as income only dividends, interest, and the income from appellant's partnership interests. After auditing appellant's returns, respondent determined that appellant was engaged in the single unitary business of renting improved real estate; Accordingly, respondent recomputed appellant's California income' by formula apportionment, including in the computation not only'the income and apportionment factors relating to the properties in Connecticut, Hawaii, and Colorado, but also appellant's 50 percent share of the income and factors of the partnership.

When a taxpayer derives income from sources both within and without this state, its franchise tax is measured by the amount of net income derived from sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer's business is unitary, the income attributable to California must be computed by formula apportionment rather than by the separate accounting method. (Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942); Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 161 (1947).) If, however, the business within this state is truly separate and distinct from the business without the state so that the segregation of income may be made clearly and accurately, the separate accounting method may properly be used. (Butler Bros. v. McColgan, supra, 17 Cal.2d at 677.)

The California Supreme Court has set forth two tests for determining whether a business is unitary. In Butler Bros., supra, the court held that the existence of a unitary business was definitely established by the presence of the three unities of ownership, operation, and use. Later, in Edison California Stores, Inc., supra, the court said that a business is unitary if the operation of the business done within this state depends upon or contributes to the operation of the business outside the state. Subsequent cases have affirmed these tests and given them broad application. (Superior Oil co. v. Franchise Tax Board, 60 Cal.2d 406 [34 Cal.Rptr. 545, 386 P.2d 33] (1963); Honolulu Oil Co. v. Franchise Tax Boar -, 60 Cal.2d 417 [34 Cal.Rptr. 552, 386 P.2d 40] (1963).)

Appellant contends that each of its real estate activities was separate and independent: the California rental activities did not, in any way, contribute to or depend upon the rental activities in Connecticut, Hawaii, or Colorado.

Respondent argues that this appeal presents a vivid example of a single corporation engaged in identical activities in four separate states, totally dependent upon appellant's three officers to make the major policy decisions with respect to the activities in each state, and to provide day-to-day guidance as to the activities in some of the states; such a major contribution is clearly indicative of the unitary nature of appellant's operations. Respondent also emphasizes its regulations which provide that where a taxpayer is engaged in the "same type of business" a "strong presumption" is created

that a single unitary business exists with respect to that taxpayer. (Cal. Admin. Code, tit. 18, reg. 25120(b) (art. 2.5).)[2/]

Upon examination, the factors relied on by respondent do not reflect such a significant relationship among the rental activities so that they all must be considered as part of a single integrated economic enterprise. At best, the suggested unitary connections are superficial and trivial. We are particularly impressed with the absence af any significant common relationship between appellant's rental activities. Each rental activity is separate and distinct. In no way do any of appellant's rental activities contribute to or 'depend upon any of the others for their success or failure. Due to the disparate nature of each of appellant's property interests and the lack of any'significant common relationship between them, we cannot conclude that these activities constitute a single economic unit. (See Appeal of Bay Alarm Company, Cal. St. Bd. of Equal.., June 29, 1982; Appeal of Hollywood Film Enterprises, Inc., Cal. St. Bd. of Equal., March 31, 1982.) There simply are no significant relationships between appellant's various rental activities which would justify a determination that the activities constituted a single unitary business under either of the two established tests.

Respondent's reliance on its regulation fares no better. Respondent argues that since all of appellant's activities are in the same general line, a strong presumption is created that the taxpayer's activities constitute a single trade or business. (See Cal. Admin. Code, tit. 18, reg. 25120(b) (art 2.5).) The simplest answer to this contention is that the presumption is not conclusive. When read in its entirety, the record will not support a conclusion that appellant's rental activities constitute a single unitary business.

2/ There are two sets of regulations (25120-25139) 'applicable for the income years on appeal--article 2 for income year 1973 and article 2.5 for income years 1974 and 1975. Since the particular sections applicable to this appeal are substantially identical under either article, reference is made only to article 2.5.

Respondent also relies on Appeal of Isidor Weinstein, Investment Co. and Appeal of The O.K. Earl Corporation, both decided April 6, 1977, to support its position that appellant's rental activities constitute a single unitary business.

Weinstein, which is simply a burden of proof case, is of little help to respondent. In that appeal, the appellant alleged that its out-of-state rental operations did not depend on or contribute to its rental operations in California. However, when the taxpayer failed to provide any evidence to support this allegation, we held that the appellant had failed to disprove respondent's determination that the rental business was unitary.

In O.K. Earl, the taxpayer was a California corporation engaged in the business of designing, constructing and managing large projects. The taxpayer owned all the stock of a Delaware subsidiary engaged in the construction business outside California. It was uncontested that the construction business was unitary. In addition, the taxpayer owned three subsidiaries that were the owners and lessors of commercial buildings that had been constructed by the taxpayer in California. At issue was whether these three subsidiaries were unitary with the taxpayer's unitary construction business. In concluding that the three subsidiaries were part of the taxpayer's unitary business we stated:

> The type of mutual dependency and contribution referred to in the Edison California Stores case is also present in this case because the acquisition of their rental properties by the three subsidiaries was an outgrowth of the parent corporation's design and construction business. It appears that in each case appellant had a client who wanted a building designed and built for its use on a lease basis. Although appellant desired to accommodate its clients in this respect, it did not want to expose its assets or activities as a general contractor to the risks inherent in becoming a landlord. For those reasons, appellant created three subsidiaries to acquire title to the properties and to act as lessors to its clients. In our opinion this clearly establishes mutual contribution and dependency between the contracting and rental activities.

In the present appeal, appellant was not currently engaged in the construction business. Furthermore, there is not even an indication that appellant's rental activities in Hawaii, Colorado, or Connecticut were an outgrowth of its prior construction business or of its desire to accommodate clients. In fact, as we have stated above, there is no significant connecting link between any of appellant's activities.. For these reasons we do not find O.K. Earl controlling.

Since, for the reasons discussed above, we have concluded that appellant is not engaged in a single unitary business, it is unnecessary to address any of the issues dealing with the apportionment formula.

Appeal of Unitco, Inc.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Unitco, Inc., against proposed assessments of additional franchise tax in the amounts of $1,732.38, $5,755.53 and $7,482.81 for the income years ended March 31, 1973, 1974, and 1975, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 21st day of June, 1383, by the State Board of Eqtialization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

_____, Member